IIMB Management Review (2012) **24**, 180—181

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BOOK REVIEW

A Colossal Failure of Common Sense — The Incredible Inside Story of the Collapse of Lehman Brothers, Larry McDonald, Patrick Robinson, Ebury Press; 2009; 351 pages.

'It's all leverage, essentially false money from false housing prices and false mortgages that may never be paid' — Mike Gelband, Former Global Head, Lehman Brothers (pp 134—135).

A Colossal Failure of Common Sense — The Incredible Inside Story of the Collapse of Lehman Brothers by Larry McDonald with Patrick Robinson is an insider's first hand report on the failure of one of the largest investment banks in the world, leading to an economic catastrophe of the magnitude the world was yet to witness. However, this is neither a fact sheet nor a research document. It is not an impartial account either — the author Lawrence McDonald was a former vice president of Lehman Brothers and among his biases is an avid dislike of bureaucracy and conventional corporate management operational policies. Once we factor in the possible results of these biases, the book provides important cues to understanding one of the most mystifying business failure stories of recent times. The book is, above all, an enjoyable read.

Before getting into the Lehman story, McDonald prepares the readers by introducing 'The Man in the Ivory Tower', Richard Fuld, then CEO of Lehman Brothers, whom Condé Nast Portfolio once named one of the worst American CEOs of all times,[1] a man whose insatiable self-interest pushed the investors' interest to a corner.[2]

The authors show that there were enough warning bells given by the analyst team to the top management about the impending mortgage bust and housing bubble. The entire mortgage industry bet on the fact that prices would keep rising in the housing sector. This ultimately led to a speculative bubble. Loans were given to borrowers with little or no creditworthiness against mortgages tagged to housing assets. In case of a housing market crash the entire risk would be transferred to the investment banks holding the Collateralised Debt Obligation (CDO)s for which the underlying assets were these mortgages. All investment banks like Lehman were thus looking at huge losses if the mortgage backed securities which were packed inside their CDOs defaulted.

The chapter on the General Electric (GE) bankruptcy case also gives some insight into the corporate activities of Lehman. The author throws some light on the dubious practices of investment banks with regard to the issue of qualified special purpose entities (QSPE) and rule 140 of the Financial Accounting Standards Board (FASB), an accounting rule that helped the banks window dress their risky assets. The GE case also highlights the indiscriminate use of Credit Default Swaps by investment bankers. ABX, the asset backed securities index, a reliable indicator of the mortgage market, which normally never went down started slipping, albeit slowly. As the mortgage market failed the tremor was felt everywhere. As it turned out, Lehman was most affected in this direction, being exposed heavily to the real estate market through CDOs and direct investments. This chapter could serve as a case study on the failure of leadership and strategic management decisions.

Towards the end this book the authors bring out the events that led to the mortgage crash. It all begun when Countrywide Financial, the number one mortgage lender in the US, could not arrange to refinance its loans. When the bank said no to Countrywide on the basis of delinquency of the assets, the panic button was hit. The shadow banking system cast the largest ever shadow on the modern financial system. Lehman management, apparently unruffled by the failure of the mortgage market, continued with their misadventures with the mortgage industry up to the point when Bear Stearns, one of the most admired securities firms in the USA, failed. The Federal Reserve System, the central banking system of the USA, had to intervene and engineer a takeover of the firm by JP Morgan Chase. The book also contains an important commentary on the road to Lehman's bankruptcy. In the epilogue McDonald suggests that the decision to let Lehman sink without a Fed engineered bail-out rested more on the personal wrath of Henry Paulson, the Secretary of the US Treasury than on economic jurisprudence.

[1] http://www.cnbc.com/id/30502091/Portfolio_s_Worst_American_CEOs_of_All_Time?slide=21.

[2] The Glucksman—Fuld episode shows Fuld's bull-headed attitude which along with that of his mentor-predecessor Lew Glucksman, led to a disaster. The ConAgra bid could be taken as a precursor to Fuld's successive backing of bad deals, deals that were overambitious and seemed oblivious of the business fundamentals pp 96—97.

Peer-review under responsibility of Indian Institute of Management Bangalore

ELSEVIER Production and hosting by Elsevier

http://dx.doi.org/10.1016/j.iimb.2012.06.005

One of the main attractions of the book is the insight into the various aspects of field level activities of investment banking. For business school students who are aspirants of an 'I-Bank' job, this provides useful tips. Some practical aspects of trading and analysis, such as the importance of fundamental analysis of credit instruments, are highlighted with examples.

One of the chapters deals with the failure of Delta Airways, a classic case of bankruptcy. There is an interesting live commentary on the author's own trading of Delta bonds that gives an insight into the actual trading scenario on the floor.[3] Elsewhere, the author introduces the concept of Collateralised Debt Obligations in layman terms. He provides us with illustrations that prove that financial business should not be sales driven at all. The author rightly points to our inability to assess impending danger through his narration of the now famous Fannie Mae story.

Another valuable contribution by Larry McDonald to the understanding of the entire domino effect of the global crisis of 2008 is his presentation of the field level picture of the mortgage business. In the opinion of this reviewer, this book is a must read for anyone interested in the crisis, if only for this reason.

The Lehman story contains all the classic ingredients of business failure — improper product design (product engineers far removed from reality), loopholes in regulatory/statutory bodies, communication failure, business intelligence failure (at least failure to give proper emphasis on the same), dubious corporate governance practices highlighting the agency problem and above all, strategic and leadership failure. Management teachers can use this as a resource for an integrated case study.

Finally, the story of the Lehman failure also points to the moral role that business education must play in the global economy. The world must realise that ethical failures of individuals ultimately lead to economic failure of the system.

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[3] pp 146—148.